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NOTES AS SECURITIES UNDER THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

Recently, federal courts have been attempting to distinguish between note instruments that are securities under the definitional sections of the Securities Act of 1933¹ and the Securities Exchange Act of 1934² and those which are not. Primarily because it has been easier to establish fraud under the civil liability provisions of the Acts³ than under common law theories of fraud,⁴ federal suits alleging fraud in note transactions have

1. Section 2(1) of the Securities Act of 1933 is codified at 15 U.S.C. § 77b(1) (1970).

2. Section 3(a)(10) of the Securities Exchange Act of 1934 is codified at 15 U.S.C. § 78c(a)(10) (1970).

3. The provisions under which civil fraud actions may be brought are section 12(2) of the 1933 Act, 15 U.S.C. § 77l(2) (1970); section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970); section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970); and rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5 (1974), which elaborates on the meaning of section 10(b) of the 1934 Act. See note 5 *infra*.

4. There was a considerable body of authority to the effect that the common law fraud requirements of reliance and scienter need not be proved in an action under rule 10b-5 or sections of the 1933 and 1934 Acts; rather, proof of the materiality of the untrue statement subsumes these elements. See, e.g., 3 L. LOSS, SECURITIES REGULATION 1702-03, 1766 (2d ed. 1961); A. BROMBERG, SECURITIES LAW: FRAUD — SEC RULE 10b-5 § 8.4 (1968); Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 371 (1967); White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974); Myzel v. Fields, 386 F.2d 718, 835 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *In re Four Seasons Securities Laws Litigation*, 370 F. Supp. 219, 236 (W.D. Okla. 1974). Other authorities, however, questioned whether negligence alone would support a private civil action under section 10(b) or rule 10b-5, or whether, instead, some type of scienter must be demonstrated. See, e.g., Comment, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1080-81 (1969); 82 HARV. L. REV. 938, 947-50 (1969); Clegg v. Conk, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975); Lamza v. Drexel & Co., 479 F.2d 1306 (2d Cir. 1973). The Supreme Court resolved this conflict of authority in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976), holding that scienter is a necessary element for a private cause of action for damages under section 10(b) or rule 10b-5. See note 5 *infra*. An action under the securities Acts retains the advantage of not requiring the proof of reliance necessary to support a common law action for fraud. See 3 Loss, *supra* at 1765.

There are other advantages to bringing suit under rule 10b-5: the class of persons that may be sued is much broader than the class that may be sued at common law, see *Gottlieb v. Sandia Am. Corp.*, 452 F.2d 510, 516 (3d Cir. 1971); a plaintiff can obtain nationwide venue and service of process, see 15 U.S.C. § 77v (1970); 15 U.S.C. § 78aa (1970); and shareholder derivative suits may be brought without providing security for the expenses of the defendant, see *Borak v. J.I. Case Co.*, 317 F.2d 838, 849 (7th Cir. 1963), *aff'd on other grounds*, 377 U.S. 426 (1964). See Comment, *The Status of the Promissory Note Under the Federal Securities Law*, 1975 ARIZ. ST. L.J. 175, 177-78. See also Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478, 503-11 (1973).

proliferated.⁵ A threshold question in these cases, however, is whether the instrument involved is a security; unless it is, the Acts are inapplicable, and there is no federal subject matter jurisdiction to determine liability.

The definitional section of the 1933 Act — section 2 — provides in part:⁶

When used in this subchapter, unless the context otherwise requires —

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3(a)(10) of the 1934 Act closely parallels this language, but excludes short-term instruments from the definition of a security.⁷ Part I of

5. A large proportion of cases under the securities Acts are brought pursuant to SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or,
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

While authorities had differed on the question whether scienter is a requirement for a private cause of action under rule 10b-5 or section 10(b) of the 1934 Act, see note 4 *supra*, this issue was recently settled by the Supreme Court in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976). A private action for civil damages was brought under section 10(b) and rule 10b-5 against the accounting firm which had audited a brokerage firm that had perpetrated a fraudulent securities scheme over a twenty year period. The plaintiff investors proceeded solely on a theory of negligent nonfeasance, there being no allegation that Ernst & Ernst had engaged in fraud or intentional misconduct. The Court engaged in a thorough review of the statute, its legislative history, the relationship of section 10(b) to other civil remedies under the Acts, and the limitation of the scope of rule 10b-5 by the statutory language and history of section 10(b), concluding that some element of scienter is necessary to support an action under section 10(b) or rule 10b-5. The *Ernst & Ernst* holding may substantially reduce the attractiveness of the securities Acts to parties alleging fraud in note transactions.

6. 15 U.S.C. § 77b (1970).

7. The term "security" means any note . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity

this Comment includes an explanation and criticism of the methods that have been used to construe the definitional sections of the 1933 and 1934 Acts; both the earlier approach of the courts, the literal method, and the current approach, "context-over-text," are considered. Part I then suggests an alternative method of construction, one which begins with the premise that the definitional terms are inherently ambiguous, thus allowing the courts to interpret words like "note" in light of the legislative purpose. In Part II a method for identifying notes that are securities and for screening out those which are not is developed from two Supreme Court cases — *SEC v. W.J. Howey Co.*⁸ and *United Housing Foundation, Inc. v. Forman*.⁹

I. METHODS OF STATUTORY CONSTRUCTION

In cases decided before 1971, courts generally held all note instruments brought before them to be securities, finding the definitional language "‘security’ means any note," plain and unambiguous.¹⁰ This literal ap-

at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1970) (emphasis added).

In Securities Act Release No. 4412, 26 Fed. Reg. 9158 (1961), the SEC articulated four criteria which formerly were applied only to exempt short-term "securities" from the registration requirements of section 3(a)(3) of the 1933 Act, 15 U.S.C. § 77c(a)(3) (1970), but which are now applied to aid in determining those short-term notes exempt from the definition of security in section 3(a)(10) of the 1934 Act. *See* *Welch Foods, Inc. v. Goldman, Sachs & Co.*, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,806 (S.D.N.Y. 1974); *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,929 (D. Minn. 1974). *See also* Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1971). The proper method of screening a short-term note for purposes of section 3(a)(10) of the 1934 Act is first to determine whether the note meets all of the technical criteria found in the SEC Release. If it does, it is a short-term note under section 3(a)(10) and therefore is not within the coverage of the 1934 Act. Even if it does not meet one or more of the criteria, however, the note should then be screened to determine whether it is a security under the test set forth in Part II of this Comment.

8. 328 U.S. 293 (1946).

9. 421 U.S. 837 (1975).

10. *See, e.g.*, *Rekant v. Desser*, 425 F.2d 872, 878 (5th Cir. 1970); *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971); *Prentice v. Hsu*, 280 F. Supp. 384, 386 (S.D.N.Y. 1968); *SEC v. Vanco, Inc.*, 166 F. Supp. 422, 423 (D.N.J. 1958), *aff'd*, 283 F.2d 304 (3d Cir. 1960).

proach¹¹ was expressed by the court in *Movielab, Inc. v. Berkey Photo, Inc.*:¹²

Upon turning to § 3(a)(10) of the 1934 Act, however, we find that it provides, in unequivocal and all-embracing language, that "The term 'security' means any note" This plain language, literally read, clearly includes promissory notes of the type that are the subject of the present suit.

Although no case using this literal approach offered any general definition, the courts apparently read the statutory term to mean the common law note instrument, which is any written paper acknowledging a debt and expressing the debtor's promise to pay.¹³ Typical of these cases is *Prentice v. Hsu*,¹⁴ where cash was given by one individual to another with the borrower's note taken in exchange. The purpose of the loan was to finance the borrower's trips from the United States to Formosa and Japan, where the borrower claimed to have cash and securities. Upon the borrower's promised return to the United States with the cash and securities, he would be obligated to invest in the lender's corporation. Although the instrument given by the defendant fits the common law definition of note, it probably is not within the "ordinary concept of a security" as envisioned

11. There are two general approaches used in construing a statute. If a court finds a statute plain and unambiguous it must apply the statutory language literally without further consideration of meaning or legislative intent. *Caminetti v. United States*, 242 U.S. 470, 485 (1917). See also 2A J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 46.04, at 54 (4th ed. 1973). On the other hand, if a court finds the statute ambiguous, it may then look into prior and contemporaneous circumstances, the harms intended to be remedied, and the legislative purpose. *Hamilton v. Rathbone*, 175 U.S. 414, 419 (1899). Sutherland suggests that modern courts no longer begin their inquiries with the language of the statute but instead go directly to manifestations of legislative intent in an effort to construe the statute. 2A SUTHERLAND § 46.07, at 65. Other materials useful in interpreting a statute are drafts of the proposed bill, legislative hearings, committee reports, debate on the bill, executive messages, speeches, and other published remarks.

12. 321 F. Supp. 806, 808 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971). In *Movielab* the plaintiff purchased film processing and optical businesses by giving two long-term promissory notes in the amount of \$5.25 million each, payable in equal monthly installments over a period of twenty years, and a short-term note in the amount of \$4.2 million. The obvious purpose of the transaction was the acquisition of defendant's businesses by plaintiff; that payment took the form of plaintiff's notes was merely incidental. Defendant very likely did not want to run the risk of investing in plaintiff's newly-acquired business and probably would have preferred payment in cash, accepting the notes as a necessary accommodation. Nevertheless, the court's literal approach converted the parties' financing arrangement into a sale of securities subject to the broad protection of the federal statutes.

13. A number of cases have undertaken to define a note at common law. See, e.g., *Kirkland v. Bailey*, 115 Ga. App. 726, 728, 155 S.E.2d 701, 703 (1967) ("The word 'note' is defined as a written paper acknowledging a debt and promising payment."); *Bates-Crumley Chevrolet Co. v. Brown*, 141 So. 436, 439 (La. 1932) ("[A] note is a written engagement or promise to pay a certain sum of money at a time specified. It is the evidence of an obligation to pay."); *Almond v. Gilmer*, 188 Va. 1, 20, 49 S.E.2d 431, 442 (1948) ("The common and accepted definition of a note is a written acknowledgment of a debt and a promise to pay.").

14. 280 F. Supp. 384 (S.D.N.Y. 1968).

by the legislative framers of the securities acts.¹⁵ Without analysis, the court held that the note was a security: "That promissory notes are within the intendment of the securities laws cannot be seriously questioned."¹⁶

Recent cases reject this literal approach.¹⁷ The reason most frequently given is that the introductory phrase "unless the context otherwise requires" is an invitation to scrutinize the particular instrument involved to see whether, in the context of the transaction, it should be regarded as a security.¹⁸ Under this method, if a court determines that a particular

15. The phrase "ordinary concept of a security" was coined in H.R. REP. No. 85, 73d Cong., 1st Sess., 11 (1933). It has become a general standard by which it is determined whether a particular instrument is included in the definitional sections of the Securities Acts. In Part II of this Comment, a method is developed that establishes with more specificity what kinds of notes come within the Acts.

Although experts in the securities field are not in total agreement, it appears that as used technically in the industry the term "note" is not simply the common law promissory note. The characteristics that distinguish the notes security from other types of notes are that these notes are generally issued by corporations, governments or other public bodies, S. KAMM, MAKING PROFITS IN THE STOCK MARKET 16, 18 (1961); H. SHERWOOD, HOW TO INVEST IN BONDS 24-25 (1974); see generally H. SAUVAIN, INVESTMENT MANAGEMENT 15-16 (1967), are bought and sold on the open market by the public, SHERWOOD, *supra* at 24-25; SAUVAIN, *supra* at 3, 15-16, and are usually bought for the purpose of realizing pecuniary gain, generally in the form of income, interest or capital gains, SAUVAIN, *supra* at 4, 8. By purchasing such an instrument the buyer runs the risk of losing the principal. *Id.* at 6-7. Nevertheless, many cases have held notes to be securities which were not in actuality of the type ordinarily thought of as securities. See *Llanos v. United States*, 206 F.2d 852 (9th Cir.), *cert. denied*, 346 U.S. 923 (1953) (cash loans used for bets on "fixed" volleyball games were given to individuals in exchange for their notes); *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989 (5th Cir. 1969) (note given to a bank in exchange for a loan). For a discussion of why a note given to a bank for a loan is not a "security," see note 68 and accompanying text *infra*.

16. 280 F. Supp. at 386. The court relied on earlier cases similarly lacking in analysis. See *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); *United States v. Monjar*, 147 F.2d 916 (3d Cir.), *cert. denied*, 325 U.S. 859 (1945); *SEC v. Vanco, Inc.*, 166 F. Supp. 422 (D.N.J. 1958), *aff'd*, 283 F.2d 304 (3d Cir. 1960). For further criticism of this case see Comment, *Commercial Notes and Definition of a "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is A Note!*, 52 NEB. L. REV. 478, 495-96 (1973).

17. See, e.g., *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *United States v. Koenig*, 388 F. Supp. 670 (S.D.N.Y. 1974); *Oxford Fin. Cos. v. Harvey*, 385 F. Supp. 431 (E.D. Pa. 1974).

18. See *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); *Avenue State Bank v. Tourtelot*, 379 F. Supp. 250 (N.D. Ill. 1974).

Several other bases have been suggested for rejecting literal construction of the definitional sections. One reason for holding that a particular note is covered by

note has not been acquired as a security, the note instrument can not provide a basis for federal jurisdiction under the securities Acts. The context-over-text method of construction originated in *Joseph v. Norman's Health Club, Inc.*,¹⁹ where the court held that two-year promissory notes given by individuals in payment for health club memberships were not securities.²⁰ The *Joseph* court reasoned first that it must adopt a flexible approach in order to cover the varied schemes of "those who seek the use of the money of others on the promise of profit."²¹ The court then considered the language opening both definitional sections — "When used in this subchapter, unless the context otherwise requires" — concluding that the context of *the transaction* required that these promissory notes not be treated as securities.²² Other courts have adopted the *Joseph* context-over-text formulation and it is now the primary means through which courts exclude certain notes from the scope of the securities Acts.²³

The conclusion that the Acts should be used to protect only certain note transactions is sound and is supported by the legislative history of the

the securities acts is that Congress intended the courts to construe the term broadly and flexibly rather than restrictively. See, e.g., *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 615 (7th Cir. 1973), *rev'd on other grounds*, 417 U.S. 506 (1974); *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154, 1178 (S.D.N.Y. 1974); *Davis v. Avco Corp.*, 371 F. Supp. 782, 786 (N.D. Ohio 1974); *SEC v. Thunderbird Valley, Inc.*, 356 F. Supp. 184, 188 (D.S.D. 1973); cf. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The continued vitality of this principle is in doubt. See note 43 *infra*. Another reason occasionally cited is the principle that courts should look to the economic realities of the transaction to determine whether the kind of instrument Congress intended to be covered by the securities acts is involved. See *Davis v. Avco Corp.*, 371 F. Supp. 782, 787 (N.D. Ohio 1974). For discussion of the present status of this principle see notes 34-36 and accompanying text *infra*. Finally, there are several cases in which courts did not explain the method of statutory construction they were using but instead merely stated that the purpose of the Acts was to protect investors, and whether a note was a security depended on whether it had been "purchased as an investment." See, e.g., *McClure v. First Nat'l Bank*, 497 F.2d 490, 492-95 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1111-16 (5th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Barthe v. Rizzo*, 384 F. Supp. 1063, 1067-68 (S.D.N.Y. 1974). These courts seem to have been relying upon legislative intent as gleaned from the legislative history of the Acts.

19. 336 F. Supp. 307 (E.D. Mo. 1971).

20. *Id.* at 313.

21. *Id.*

22. The court failed to articulate any standards for assessing transactions, merely concluding that, in this transaction, the notes were not securities: "This Court is of the opinion that the context of the present case . . . requires that the promissory note is other than a security within the meaning of § 10b." *Id.*

23. See, e.g., *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,929 (D. Minn. 1974); *United States v. Koenig*, 388 F. Supp. 670 (S.D.N.Y. 1974); *Oxford Fin. Cos. v. Harvey*, 385 F. Supp. 431 (E.D. Pa. 1974); *Avenue State Bank v. Tourtelot*, 379 F. Supp. 250 (N.D. Ill. 1974).

Acts;²⁴ however, the courts' notion that "context" means context of the transaction seems flawed. The more proper construction appears to be that "context" refers to the context of the statute. Thus, in *SEC v. National Securities, Inc.*,²⁵ the Supreme Court, in construing the "purchase or sale" language of rule 10b-5, explained:

[O]rdinary rules of statutory construction still apply. The meaning of particular phrases must be determined in context. . . . Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context otherwise requires."²⁶

Despite this authoritative interpretation, the lower federal courts have continued to use "context" as an excuse for examining the transactions to determine whether a "security" has been traded. Perhaps the motivation for this has been a reluctance on the part of federal courts to make themselves available to any plaintiff who might have been defrauded in a transaction involving a common law note. Nevertheless, the interpretation does violence to the statutory language; the construction set forth in *National Securities*, in addition to being that offered by the Supreme Court, is more reasonable and logical than that followed by the lower courts, and should be adopted generally.

Such an adoption, however, will not by itself provide a basis for distinguishing between "note securities" and all other common law notes. The context of none of the anti-fraud provisions of the securities Acts indicates anything about the meaning of "note." Thus, despite the lower court decisions, it appears that the language "unless the context otherwise requires" does not answer the question whether some notes, *i.e.*, note securities, are included under the scope of the Acts while others are not. The proper focus in resolving this question must be on construing the word "note" itself.

As used in the definitional sections, the word "note" is ambiguous because it may refer either to the broad class of all common law notes or to the narrower subclass of note securities. Because of this ambiguity, further illumination on the intended meaning of the term must be sought.

In *United Housing Foundation, Inc. v. Forman*²⁷ the Supreme Court was faced with a similar problem — how to construe the terms "stock, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a 'security,'" which also appear in the definitional sections of the 1933 and 1934 Acts as classes of securities.²⁸ *United Housing Foundation* involved the purchase of shares of "stock" in a non-profit housing cooperative in New York City. The purpose of the transaction

24. See H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933).

25. 393 U.S. 453 (1969).

26. *Id.* at 466.

27. 421 U.S. 837 (1975).

28. See notes 6-7 and accompanying text *supra*.

was to entitle the buyers to occupy apartments in the low cost cooperative. The Court held that these shares were not securities. At the outset, the Court rejected the literal method of construing the definitional sections, stating that the stock purchasers' reliance on *SEC v. C.M. Joiner Leasing Corp.*²⁹ was misplaced.³⁰ In *Joiner* the statement had been made that "[i]nstruments *may* be included within [the definition of a security], as [a] matter of law, if on their face they answer to the name or description."³¹ The Supreme Court called this *Joiner* statement dictum, adding that in any case the use of the words "may" and "might" made it clear that the *Joiner* Court was not establishing an inflexible rule; rather, it was merely pointing out that in many instances instruments bearing one of the statutorily enumerated titles are likely to be included within the statutory coverage.³² The Court held that "the name given to an instrument was not dispositive."³³ Instead, it adopted as the appropriate method of construction the "economic realities" approach³⁴ first articulated in *SEC v. W.J. Howey Co.*³⁵ and later applied in *Tcherepnin v. Knight*.³⁶ Under this approach a court focuses on the characteristics of the instrument and the circumstances of the transaction in order to determine whether the transaction is of the kind intended by Congress to be controlled by the securities Acts.

Thus, in *Howey* the instruments involved were land sales contracts. A large citrus grower sold small sections of its groves to mainly out-of-state purchasers. Under the terms of a service contract usually accompanying the sale contracts, the land remained in the possession of the grower whose size allowed for efficient agricultural operation. The buyers typically were business and professional people seeking a promised high return on invested capital. The Supreme Court had no difficulty concluding that the land sales contracts were "investment contracts" and thus "securities" within the intendment of the Acts.³⁷

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

The Court disregarded the "form" of the transaction (and the substantial fact that the buyers received not only an instrument, but also land with at

29. 320 U.S. 344 (1943).

30. 421 U.S. at 849-50.

31. *Id.* at 850, quoting from 320 U.S. at 351.

32. 421 U.S. at 848-51.

33. *Id.* at 850.

34. *Id.* See *Great Western Bank & Trust v. Kotz*, CCH FED. SEC. L. REP. ¶ 95,494, at 99,499 (9th Cir., Mar. 22, 1976).

35. 328 U.S. 293, 298 (1946).

36. 389 U.S. 332, 336 (1967).

37. 328 U.S. at 298-99.

least some value independent of the common enterprise) and focused on "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."³⁸

Again, in *Tcherepnin v. Knight* the Court looked to the economic reality of the transaction, holding that "withdrawable capital shares" in a savings and loan association were securities within the meaning of the 1934 Act.³⁹ Applying this method to the "stock" involved in *United Housing Foundation*, that Court reasoned:⁴⁰

These shares have none of the characteristics "that in our commercial world fall within the ordinary concept of a security." Despite their name, they lack what the Court in *Tcherepnin* deemed the most common feature of stock: the right to receive "dividends contingent upon an apportionment of profits." Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value. In short, the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.

It should be noted that the Court's rejection of the literal approach in *United Housing Foundation* was not without qualification. In a somewhat vaguely stated dictum, the Court suggested that justifiable reliance on names will be protected:⁴¹

There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Thus the name given to an instrument and the significance attached to the name by the parties to the transaction appear to be part of the "economic realities" to be considered in determining whether the Acts apply.

The Court also ruled that the cooperative housing shares were neither an "investment contract" nor other "interests or instrument commonly known as a 'security.'" Again, the Court stressed that the "economic realities" of the transaction would control. Here, however, the Court, quoting from its earlier decision in *Howey*, formulated something of a general rule to be used in assessing disputed transactions.⁴²

In either case, the basic test for distinguishing the [protected] transaction from other commercial dealings is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." This test, in shorthand form, em-

38. *Id.* at 301.

39. 389 U.S. at 338.

40. 421 U.S. at 851 (citations omitted).

41. *Id.* at 850-51.

42. *Id.* at 852.

bodies the essential attributes that run through all of the Court's decisions defining a security.

The method developed by the Supreme Court in *Howey* and *Tcherepnin* and given broad application in *United Housing Foundation* offers a sensible approach for determining whether a particular note transaction is within the purview of the securities Acts.⁴³ Part II of this Comment is an attempt to develop this approach.

II. AN ALTERNATIVE APPROACH

Recent lower court cases that have employed the context-over-text approach⁴⁴ have not been entirely clear on what characteristics of the transaction are important in determining whether the instrument involved is a note security within the securities Acts. Most courts agree that each disputed transaction must be dealt with on the basis of its own probably unique factual pattern. Nevertheless, because one of the purposes of the

43. The method of construction developed in *United Housing Foundation* will probably modify a concept set forth in *Tcherepnin v. Knight*, 389 U.S. 332, 336, 338 (1967):

[W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act clearly falls into the category of remedial legislation. . . .

Even a casual reading of §3(a)(10) reveals that Congress did not intend to adopt a narrow or restrictive concept of a security in defining that term. *Tcherepnin* was cited frequently for the principle that courts are obliged to tip the scales in favor of establishing jurisdiction over securities transactions, not narrowing it. *E.g.*, *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 615 (7th Cir. 1973), *rev'd on other grounds*, 417 U.S. 506 (1974); *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154, 1178 (S.D.N.Y. 1974); *Davis v. Avco Corp.*, 371 F. Supp. 782, 786 (N.D. Ohio 1974); *SEC v. Thunderbird Valley, Inc.*, 356 F. Supp. 184, 188 (D.S.D. 1973). After *United Housing Foundation*, however, federal courts should not simply state that *Tcherepnin* requires a broad, liberal construction of the definitional sections and then hold, without further reasoning or explanation, that the notes before them are securities. *United Housing Foundation* now requires that a court look at the characteristics of the instrument and the circumstances of the transaction to determine whether the instrument is of a type ordinarily thought to be a security. A concomitant effect of the principle that the definitional sections are to be construed broadly has been a narrow construction of the exemption in section 3(a)(10) of the 1934 Act, *see* note 7 *supra*, for short-term notes having a maturity of nine months or less. *See, e.g.*, *Zabriskie v. Lewis*, 507 F.2d 546, 550 (10th Cir. 1974); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 524 (5th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 799-800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079-80 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,929 (D. Minn. 1974); *Welch Foods, Inc. v. Goldman, Sachs & Co.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,806 (S.D.N.Y. 1974); *Crowell v. Pittsburgh & Lake Erie R.R.*, 373 F. Supp. 1303, 1307-08 (E.D. Pa. 1974).

44. *See* notes 17-23 and accompanying text *supra*.

securities Acts is to protect investors,⁴⁵ many courts have indicated that the basic inquiry is whether the note transaction constitutes an investment or is merely "commercial,"⁴⁶ although the limited meaning attached to this latter term is never made clear in the cases. The various factors that have appeared in disputed note transactions are then assessed for their classificatory value under this investment/commercial test.⁴⁷

There are several difficulties with this approach. First, the classificatory value of these factors will not remain constant from transaction to transaction, but will vary somewhat depending on the other factors present.⁴⁸ Thus, as an analytical tool the investment/commercial dichotomy has only limited value.⁴⁹ More seriously, the basic inquiry seems flawed. Implicit in the dichotomy is the false assumption that any note that is not an investment is necessarily a commercial note; a personal I.O.U., for example, would seem not to fit in either category.⁵⁰ Also implicit is

45. There is considerable language in the legislative history of the Acts indicating Congress' concern with fraud and misrepresentation practiced on investors. *See, e.g.*, S. REP. NO. 792, 73d Cong., 2d Sess. 3, 18 (1934); S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933) ("The purpose of this bill is to protect the investing public. . . . The basic policy is that of informing the investor of the facts concerning securities . . . and providing protection against fraud and misrepresentation."); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 1 (1934). *See also* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975); 78 CONG. REC. 2264 (1934) (President Roosevelt's February 9, 1934, message to Congress); 77 CONG. REC. 937 (1933) (President Roosevelt's March 29, 1933, message to Congress).

46. *See, e.g.*, C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); United States v. Koenig, 388 F. Supp. 670 (S.D.N.Y. 1974); Oxford Fin. Cos. v. Harvey, 385 F. Supp. 431 (E.D. Pa. 1974); Davis v. Avco Corp., 371 F. Supp. 782 (N.D. Ohio 1974); Thorp Commercial Corp. v. Northgate Indus., Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,929 (D. Minn. 1974). Other cases have expressed concern only with the investment nature of the transaction, not with its commercial nature. *See, e.g.*, Alberto-Culver Co. v. Scherk, 484 F.2d 611 (7th Cir. 1973), *rev'd on other grounds*, 417 U.S. 506 (1974); Barthe v. Rizzo, 384 F. Supp. 1063 (S.D.N.Y. 1974); Hall v. Security Planning Serv., Inc., 371 F. Supp. 7 (D. Ariz. 1974).

47. *See* Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478, 510-23 (1973).

48. Thus, investor naivete may be important in some cases, *see, e.g.*, Davis v. Avco Corp., 371 F. Supp. 782 (N.D. Ohio 1974), but unimportant in others, for example, where the investor is active in the management of the enterprise, *see, e.g.*, C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Oxford Fin. Cos. v. Harvey, 385 F. Supp. 431 (E.D. Pa. 1974).

49. *See, e.g.*, McClure v. First Nat'l Bank, 497 F.2d 490, 492-95 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); United States v. Koenig, 388 F. Supp. 670, 714 (S.D.N.Y. 1974); Oxford Fin. Cos. v. Harvey, 385 F. Supp. 431, 435 (E.D. Pa. 1974).

50. Courts using the term "commercial" have failed to explain its meaning, and the word does not have a well-established usage in the securities field. Both Congress and the Supreme Court have indicated that securities sometimes are issued in com-

the notion that any note transaction that can be characterized as an investment comes within the purview of the Acts. But investment is not a term of art; it has application to a wide variety of personal and commercial situations, only some of which seem appropriately protected by the Acts. Further refinement of the terminology seems necessary, yet the cases employing the investment/commercial test offer little assistance.

The Supreme Court's statement in *United Housing Foundation* that the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security"⁵¹ suggests that this test should help in the difficult process of determining whether a note is a security. The test consists of four elements. There must be 1) an investment of money 2) in a common enterprise 3) with an expectation of profits 4) to be derived solely from the efforts of others.

The first element, investment of money, suffers from the same lack of refinement of language apparent in the investment/commercial test. If investment is taken to be a term of art, however, its utility is greatly increased.

Experts in the securities field define "securities" partly in terms of risk of loss.⁵² This concept was first considered by the legal community in *Silver Hills Country Club v. Sobieski*.⁵³ The California Supreme Court there announced its determination that "risk capital" was an important means of defining the term security.⁵⁴ Professor Coffey later expanded this concept, establishing it as his major premise:

[R]isk to initial investment, though not determinative, is the single most important economic characteristic which distinguishes a security from the universe of other transactions.⁵⁵

Risk of loss is an important concept because it isolates and emphasizes the major danger to an investor — the possibility of losing all the money

mercial settings, thus making those security instruments "commercial." See, e.g., H.R. REG. No. 85, 73d Cong., 1st Sess. 11 (1933) ("Paragraph (1) defines the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975) ("[T]he basic test for distinguishing the [protected] transaction from other commercial dealings is [the *Howey* test].")

Some focus on the "investment" nature of a transaction seems appropriate, however, in light of the well-established usage of that term in the legislative history of the securities Acts and investment contract cases. See note 45 *supra*.

51. See text accompanying note 42 *supra*.

52. See SAUVAIN, *supra* note 15, at 6-7.

53. 55 Cal. 2d 811, 361 P.2d 906 (1961).

54. *Id.* at 814, 361 P.2d at 907. In *Silver Hills* the court held that purchases of memberships in a seriously under-capitalized country club constituted purchases of securities under CAL. CORP. CODE § 25019 (West 1971).

55. Coffey, *The Economic Realities of a "Security": Is There A More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 375, 381 (1967). Professor Coffey identifies the source of the risk of loss requirement as SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943). See also *Great Western Bank & Trust v. Kotz*, CCH FED. SEC. L. REC. ¶ 95,494, at 99, 499-500 (9th Cir., Mar. 22, 1976).

or other property contributed to an enterprise. In passing the 1933 and 1934 Acts, Congress was concerned primarily with protecting the investing public.⁵⁶ If an investor incurs no risk of loss, then there is no need for the protection offered by the securities Acts.

One way in which capital is subjected to substantial risk of loss is through contribution to a young, unproven enterprise. Even if all the circumstances known (*e.g.*, officers in the corporation, marketability of the product, feasibility of the operations) point to the likelihood of a successful venture, there remains the possibility that unforeseen circumstances will quickly reduce the assets of the business, leaving insufficient funds to repay a note creditor. A recent district court case illustrates the substantial risk of loss inherent in a contribution to a new corporation. In *Barthe v. Rizzo*⁵⁷ the plaintiff was the payee on a \$93,000 note. The payor was a newly-formed corporation which intended to use the contributed funds as venture capital. Barthe had been induced to contribute to this corporation by the defendant who, for many years, had been retained by Barthe to invest Barthe's money in securities of defendant's choosing. Defendant eventually formed a plan to defraud plaintiff. Pursuant to this plan, he advised plaintiff to take the new corporation's note for \$93,000, payable at an interest rate of seven percent, while unbeknownst to plaintiff, defendant passed off the contribution of \$93,000 as his own. The court found that "the loan was meant to be seed money for a venture capital deal Under these circumstances, the note falls squarely under the protective umbrella of the securities laws."⁵⁸

56. See note 45 *supra*.

57. 384 F. Supp. 1063 (S.D.N.Y. 1974).

58. *Id.* at 1068. *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974), presents a situation analogous to *Barthe*. In *Zabriskie* an unsophisticated individual was persuaded to loan sums of money to a closely-held corporation so that it could be "promoted." It is difficult to discern whether the court was describing the promotion of a newly-formed or a mature corporation. The court characterized this transaction as the kind in which stock often is given. *Id.* at 551, citing Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note Is a Note?*, 52 NEB. L. REV. 478, 501 (1973). This formulation suggests a new perspective from which to analyze *Barthe*. The plaintiff in *Barthe* supplied all of the corporation's cash funds but received only four and a half percent of its stock, with the remainder of his investment represented by a note. Because the plaintiff was the source of the entire corporate treasury, he stood at the "front lines of risk" as a participant in the enterprise. There was no common stock which provided an equity fund to serve as a buffer for the note creditor. The capital furnished by the note payee therefore functioned in a manner similar to common stock. Professor Coffey has developed the concept of "front lines of risk." See Coffey, *supra* note 4, at 386. He distinguishes debt securities from others because they are generally far removed from the front lines of risk — junior investments, usually common stock, cushion the creditor against corporate losses. The logical extension of this concept is that when a debt security provides all of a corporation's treasury, it functions much like common stock and should be regarded as a security so long as other characteristics of a security are present.

Capital is also placed at substantial risk when it is contributed in an attempt to resuscitate an unsuccessful enterprise. If the enterprise continues to operate at a loss, then the chance of recouping contributed capital becomes increasingly small. *SEC v. Continental Commodities Corp.*⁵⁹ introduced the concept that the resuscitative nature of a note was a meaningful indication that it was a security. The SEC sued to enjoin the defendant from violating registration and fraud provisions of the 1933 and 1934 Acts. The nature of defendant's business was to acquire commodities futures options for its customers and then advise them as to the most propitious time to sell the futures contracts. The customers deposited sums of money in "accounts" with defendant to cover forthcoming acquisitions and services. Defendant had misrepresented its solvency and the lucrative-ness of trading in future and the SEC therefore suspended its trading indefinitely. Defendant then offered to pay its customers sixty percent of the money owed them immediately, and to issue notes to the customers for the remaining forty percent. In return for the notes, the customers agreed to forbear from bringing suit.⁶⁰ These notes were one basis for jurisdiction alleged by the SEC in its suit against defendant.⁶¹ The Fifth Circuit held that the notes were securities, and were therefore a basis for jurisdiction, because the resuscitative nature of the contribution established that the notes had been acquired as investments: "Since revival would inure to their benefit, recipients accepted the notes with the hope of realizing a greater return on their investments."⁶² Thus, there were two important reasons for concluding the notes were securities. The note payees were willing to risk the money that they might otherwise have received as damages in an action to liquidate, and they did so in hopes of receiving a greater sum if they forebore from bringing suit and permitted defendant to continue its operation.

A third situation the presence of which may indicate substantial risk to contributed capital is inadequate collateralization. Looking to the two extremes possible with regard to collateralization, the governing principle becomes apparent. On the one hand, collateral that is many times more valuable than the face amount of the note and that is not susceptible to market fluctuation would tend to make the transaction risk-free and there-

59. 497 F.2d 516 (5th Cir. 1974).

60. The question arises whether forbearance can constitute a contribution. Professor Coffey explains that the value furnished by an investor can take a variety of forms; for example, money, property or services. See Coffey, *supra* note 4, at 380. Forbearance from bringing a liquidation action seems in the same category as the forms listed by Coffey. The value risked by the contributor is that amount which could have been recovered in an action to dissolve the corporation and liquidate its assets. Similarly, the corporation received a contribution in that the forbearance left it with some operating capital.

61. 497 F.2d at 519. The other basis of jurisdiction alleged was that the trading accounts themselves were investment contracts. The court concluded that either allegation satisfied the jurisdictional requirement of a "security."

62. *Id.* at 527.

fore not a security transaction within the securities Acts. On the other hand, with a note secured by no collateral the risk of loss would be substantial. Degrees of collateralization between these two extremes are possible and there is no precise point at which to conclude unequivocally that the note becomes risk-free. This is a decision for the finder of fact, and several factors should be considered in light of the purposes of the securities Acts, including the value of the collateral in relation to the face amount of the note, the form of the collateral, and its susceptibility to market fluctuations.

One court recently has suggested that collateralization is a factor to consider in determining whether a note is a security.⁶³ Indeed, most cases in which notes were collateralized have held that the notes in issue were not securities.⁶⁴ It is probable that the existence of collateral contributed to these decisions. Forms of collateral used in these cases included deeds of trust on real property,⁶⁵ chattel mortgages on the fixtures of a business,⁶⁶ and the accounts receivable of a business.⁶⁷ Real property and fixtures tend to be less susceptible to market fluctuations than do notes, making the transactions involved relatively risk-free. The lenders in most of these collateralization cases were banks or other lending institutions. Such sophisticated entities normally will ensure that there is an appropriate correlation between the value of the collateral and the face amount of the note.⁶⁸

63. In *Great Western Bank & Trust v. Kotz*, CCH FED. SEC. L. REP. ¶ 95,494, at 99,500 (9th Cir., Mar. 22, 1976), the Ninth Circuit identified the "existence and extent of collateralization" as an important factor in determining whether a corporate note given to a bank in exchange for a line of credit was a security. The court held that the note given to the bank in a commercial financing transaction was not a security, in part because the loan agreement required the corporate note issuer to maintain a sizeable account with the bank as partial security. *Id.* at 99,501. See also *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1230 n.14 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).

64. See, e.g., *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,929 (D. Minn. 1974); *Avenue State Bank v. Tourtelot*, 379 F. Supp. 250 (N.D. Ill. 1974).

A few courts have held that notes were securities despite the fact that they were collateralized. See *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *SEC v. Thunderbird Valley, Inc.*, 356 F. Supp. 184 (S.D.S.D. 1973). In *Zabriskie* it appeared that the collateral given was worth very little in comparison to the amount loaned. In *Zeller* and *Thunderbird Valley* it is unclear what the relationship was between the value of the collateral and the value of the note.

65. *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974).

66. *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

67. *Avenue State Bank v. Tourtelot*, 379 F. Supp. 250 (N.D. Ill. 1974); *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,929 (D. Minn. 1974).

68. Banks and other lending institutions that invest their depositors' funds in a fiduciary capacity and are required to invest prudently. See generally Note, *The Regu-*

In the cases involving accounts receivable, for example, it appeared that there was a substantial margin between the value of the accounts and the value of the notes.⁶⁹

The second element in the *Howey* test is the requirement that the investment be in a common enterprise. Judicial discussion of the nature of a common enterprise thus far has been confined to investment contract cases, where two schools of thought regarding the definition of "common enterprise" have developed. The conservative view, espoused by the Seventh Circuit in *Milnarik v. M-S Commodities, Inc.*,⁷⁰ is that there must be a pooling of funds, through contribution by a number of contributors to a common promoter, with a pro-rata sharing of profits.⁷¹ The Fifth and Ninth Circuits, on the other hand, do not regard a common enterprise as requiring a pooling of funds or pro-rata sharing of profits, but insist only that "the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."⁷² In *Rochkind v. Reynolds Securities, Inc.*⁷³ a federal district court applying the more liberal formulation included as a common enterprise a situation in which a single contributor relied on the efforts of a promoter.⁷⁴ The underlying dissimilarity between the two schools appears to be in the differing weights assigned to the competing principles involved. The liberal school appears to favor the principle embodied in the securities Acts of providing liberal federal relief to victims of investment frauds;⁷⁵ the conservative school appears to favor the competing principle of federal judicial economy, thus denying relief where merely private fraud is involved.

Whichever approach is adopted, it seems necessary to examine both the issuing entity and the recipient in a note transaction. For a note to be a security the issuing entity generally should be a business enterprise or governmental body. This conclusion follows from the propositions that

lation of Risky Investments, 83 HARV. L. REV. 603, 608-16 (1970); 12 C.F.R. §§ 1.1-12 (1974). Therefore, they are under a duty to invest in enterprises which have proven or are likely to prove successful. Presumably, they must also secure loans with a safe margin between the value of the collateral and the face amount of the note. For a discussion of the impropriety of classifying as securities notes from borrowers held by commercial banks, see *Great Western Bank & Trust v. Kotz*, CCH FED. SEC. L. REP. ¶ 95,494, at 99,502-04 (9th Cir., Mar. 22, 1976) (Wright, J., concurring).

69. See, e.g., *Avenue State Bank v. Tourtelot*, 379 F. Supp. 250 (N.D. Ill. 1974), where a note for \$220,000 was secured by accounts receivable valued at over \$500,000.

70. 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972); see *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972), aff'd, 491 F.2d 752 (3d Cir. 1973).

71. 457 F.2d at 278.

72. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974), quoting from *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7 (9th Cir.), cert. denied, 414 U.S. 821 (1973); see *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224 (9th Cir. 1974), cert. denied, 419 U.S. 900 (1975).

73. 388 F. Supp. 254 (D. Md. 1975).

74. *Id.* at 257.

75. See note 45 *supra*.

the term "note" appearing in each of the definitional sections refers only to those notes commonly regarded as securities in the commercial world,⁷⁶ and that in the commercial world the only type of instruments commonly regarded as securities are those issued by business enterprises and governmental bodies.⁷⁷ The entities included within this approach are diverse: corporations, partnerships, and less formal associations of individuals acting together for a business purpose are all "business enterprises."

Notes of individuals ordinarily should not be regarded as securities, particularly when they are not given in pursuit of a business objective.⁷⁸ Several courts have characterized notes given by individuals in payment for consumer goods as the kind of notes that are not securities.⁷⁹ To these should be added notes given as payment for other kinds of goods, rights, and services, and notes given in exchange for loans of money for personal

76. See *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975).

77. See note 15 *supra*.

78. In only two recent cases have courts held that the notes of individuals were securities under the Act, and both courts reached that decision through faulty analysis. See *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154 (S.D.N.Y. 1974); *Davis v. Avco Corp.*, 371 F. Supp. 782 (N.D. Ohio 1974). The plaintiffs in *Davis* were victims of the pyramid scheme Dare To Be Great. For a detailed description of the Dare To Be Great system, see *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 479-80 (9th Cir. 1973), and Note, *Dare To Be Great, Inc.: A Case Study of Pyramid Sales Plan Regulation*, 33 OHIO ST. L.J. 676, 677-86 (1972). The Dare To Be Great system sought persons who would purchase the right to attend classes and obtain other instructional materials on how to be successful in business. This opportunity usually was purchased for about \$1000, with more expensive opportunities, consisting of privileges to sell the scheme to others, available for multiples of the basic price. The defendant in *Davis* was a finance company that operated in conjunction with Glenn Turner Enterprises, the Dare To Be Great corporation. The defendant made representations to the plaintiffs that Dare To Be Great was a sound investment. On these facts, the court concluded that the promissory notes issued by the plaintiffs in payment for Dare To Be Great opportunities were securities. 371 F. Supp. at 788.

The court stated that the basis of its holding was that the plaintiffs were unsophisticated investors (in Dare To Be Great). *Id.* at 787-88. However, the court's reasoning was faulty. For the notes to constitute securities, Avco, the note recipient, would have had to be the investor. By the court's own declaration, plaintiffs were the investors. *Id.* If the interests purchased by the plaintiffs were embodied in instruments, very possibly plaintiffs were investors *with respect to those instruments*. Conversely, the supposed legal rights obtained by Avco were embodied in instruments, the plaintiffs' notes. Avco was therefore the "investor" vis-à-vis those notes, yet the court viewed the "investment" as being made by the note issuers.

Ingenito involved a similar factual situation. As in *Davis*, the *Ingenito* court focused on the wrong parties as investors, concluding that the notes of a large group of unsophisticated individuals were securities. 376 F. Supp. at 1180.

79. *E.g.*, *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1359-60 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689, 695 (3d Cir. 1973); *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,929, at 97,211 (D. Minn. 1974); *cf. McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *United States v. Koenig*, 388 F. Supp. 670 (S.D.N.Y. 1974).

use. *Joseph v. Norman's Health Club, Inc.*⁸⁰ is a good illustration. Plaintiffs received lifetime membership in the defendant health club in return for their notes for \$360, payable in twenty-four monthly installments. The court rejected plaintiffs' argument that the notes they had given were securities and within the coverage of rule 10b-5,⁸¹ holding that under the facts presented these promissory notes were not securities.

Focusing on the recipients rather than the issuers of securities, courts frequently have stated that for notes to be securities they must be distributed in a public, not a private, transaction.⁸² By public distribution courts generally have meant that the notes were acquired by a large number of recipients or that an unsophisticated person was the purchaser, or that both factors were present. In *Davis v. Avco Corp.*⁸³ there were many victims of the fraudulent scheme; the court stated:⁸⁴

The complaint indicates that plaintiff and the members of the class he represents were a group of unsophisticated investors who probably did not understand the potential (and likely) risks to the money they were investing Here were unsophisticated investors, with little knowledge or understanding of the likely risks their investment faced It appears that these are the very kinds of transactions which Congress intended to sweep under the umbrella of the anti-fraud provisions of the securities laws. . . .

For these reasons this Court holds that, based on the allegations in the complaint, these promissory notes constitute securities within the meaning of 15 U.S.C., §§ 77b(1) and 78c(a)(10).

When large numbers of recipients are involved, a major concern is the widespread public harm that may be caused. It has even been stated that a serious threat of public harm is created when a large number of shareholders may be adversely affected by a fraud perpetrated against a single corporate note payee. Thus, in *Crowell v. Pittsburgh & Lake Erie Railroad*⁸⁵ the court held that notes issued by a parent to a subsidiary corporation with a significant public ownership were securities.⁸⁶ Purchasers of instruments who are not familiar with the issuer's business, given their limited access to accurate, detailed information about the issuer, are particularly susceptible to misrepresentation. Thus, the protection of the prophylactic and remedial measures of the federal securities Acts is warranted. Even single members of the public have been held to merit this protection so long as they are unsophisticated.⁸⁷ And the lack of sophisti-

80. 336 F. Supp. 307 (E.D. Mo. 1971).

81. See note 5 *supra*.

82. E.g., *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 526-27 (5th Cir. 1974); *Barthe v. Rizzo*, 384 F. Supp. 1063, 1068 (S.D.N.Y. 1974). See also Coffey, *supra* note 4, at 371.

83. 371 F. Supp. 782 (N.D. Ohio 1974), discussed in note 78 *supra*.

84. *Id.* at 787-88.

85. 373 F. Supp. 1303 (E.D. Pa. 1974).

86. *Id.* at 1308.

87. See *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974); cf. *Barthe v. Rizzo*, 384 F. Supp. 1063 (S.D.N.Y. 1974).

cation requirement does not exclude from protection large, experienced investors if they are unfamiliar with the particular issuer's business.⁸⁸

The third *Howey* criterion, expectation of a profit, has been discussed infrequently by the courts. Two cases, however, have rested their holdings that the instruments involved were not securities in part on the absence of a profit-motive. The Supreme Court held in *United Housing Foundation* that the instruments involved were neither stocks, investment contracts, nor any other type of security, in part because the plaintiffs had not acquired the shares for the purpose of making a profit.⁸⁹ The considerable emphasis afforded the absence of a profit motive in *United Housing Foundation* may indicate the Court's judgment that an expectation or intention of realizing a profit is a *necessary* element of any security.⁹⁰ In *Rosen*

88. See *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973) ("[S]ophisticated investors, like all others, are entitled to the truth."); *Barthe v. Rizzo*, 384 F. Supp. 1063, 1067 (S.D.N.Y. 1974); *Welch Foods, Inc. v. Goldman, Sachs & Co.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,806, at 96,685 (S.D.N.Y. 1974). In *Welch Foods*, Welch, the purchaser of Penn Central notes, had considerable sophistication and knowledge in the commercial world. However, it was familiar neither with the operation of Penn Central nor with the railroad industry in general, and the court therefore permitted it to sue under the federal securities Acts.

Banks and other lending institutions, on the other hand, are frequently, if not always, excluded as investors under the securities Acts. See, e.g., *Great Western Bank & Trust v. Kotz*, CCH FED. SEC. L. REP. ¶ 95,494, at 99,502-04 (9th Cir., Mar. 22, 1976) (Wright, J., concurring); *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974); *Avenue State Bank v. Tourtelot*, 379 F. Supp. 250 (N.D. Ill. 1974); *Thorp Commercial Corp. v. Northgate Indus., Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,929 (D. Minn. 1974). The reason may be that banks are usually the single payees on notes given in loan transactions and they are sophisticated agents in the lending field. While they may not be familiar with the borrower's particular business, they probably do have the expertise to make a reasonable forecast of the likelihood of success of that business, and in any event would take sufficient collateral so as to minimize the risk of loss. See note 68 *supra*.

89. 421 U.S. at 859-60.

90. The *United Housing Foundation* Court based its conclusion that the cooperative housing shares at issue were not securities largely on the absence of a profit motive. Rejecting the contention that the shares were "stocks," and therefore securities within the Acts, the Court stated that they lacked "the most common feature of stock: the right to receive 'dividends contingent upon an apportionment of profits,'" 421 U.S. at 851, and that "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit." *Id.* Later, in applying the *Howey* test to hold that the shares were not investment contracts, the Court observed that [i]n the present case there can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments. . . . In short, neither of the kinds of profits traditionally associated with securities was offered to respondents.

Id. at 853-54. And in concluding its opinion, the Court stated:

[w]hat distinguishes a security transaction — and what is absent here — is an

*v. Dick*⁹¹ the promissory note of an individual was accepted in settlement of potential claims against him for his fraudulent acts. Because these sums functioned as restitution for injury rather than as profit on an investment, the note was held not to be a security.⁹²

Profits generally take one of two forms — income or capital appreciation.⁹³ With equity instruments such as common stock, income normally is earned by the corporation and then distributed to the shareholders as dividends.⁹⁴ With debt securities such as notes, however, income usually takes the form of interest paid regardless of whether the business has profited. Although a note payee most frequently intends to earn profits in the form of interest, a note conceivably could be drafted so that the payee would earn profits by participation in the earnings of the enterprise. This arrangement would seem also to satisfy the profits requirements.

Where a note does not expressly recite that the payee either will be paid interest or will participate in the earnings of the business, courts should scrutinize closely the motive of the purchaser. The payee may well have taken the note for some reason other than to earn profits, for example, the loan might have been motivated purely by social or personal reasons or perhaps taken as payment for goods.⁹⁵ In such cases, the note should not be deemed a security. On the other hand, a non-interest bearing note may have been purchased for the purpose of realizing capital appreciation. In *SEC v. Continental Commodities Corp.*, discussed earlier,⁹⁶ the corporation returned sixty percent of the funds deposited with it by its clients.

investment where one parts with his money in the hope of receiving profits from the efforts of others. . . .

Id. at 858.

91. [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,786 (S.D.N.Y. 1974).

92. *Id.* at 96,605. The fact that the issuer was not a business or governmental entity also may have contributed to the court's decision. See notes 76-81 and accompanying text *supra*.

93. SAUVAIN, *supra* note 15, at 8. The Supreme Court used a slightly different formulation when discussing investment contracts in *United Housing Foundation*, describing the two kinds of profits as "capital appreciation resulting from the development of the initial investment" and "a participation in earnings resulting from the use of investors' funds." 421 U.S. at 852.

94. This is commonly referred to as participation in the earnings of the enterprise.

95. See *Lino v. City Investing Co.*, 487 F.2d 689, 695 (3d Cir. 1973). In *Lino* the plaintiff was an individual who gave his note to a corporation in payment for a franchise interest. The Third Circuit felt that it was illogical to describe plaintiff's note as having been "purchased" through payment to him of the right to operate the franchise. *Id.* For that reason, the court held that the note was not a security. This is an expedient means of eliminating from the definitional sections of the Acts any notes which are given in payment for property, services, or rights, where it is clear that the recipient has no interest in investing in the issuer's business and has accepted a note only because a more desirable form of payment, *e.g.*, cash, is unavailable. This theory may also explain the holdings in *Alberto-Culver Co. v. Scherk*, 484 F.2d 611 (7th Cir. 1973), and *Joseph v. Norman's Health Club, Inc.*, 336 F. Supp. 307 (E.D. Mo. 1971).

96. See notes 59-62 and accompanying text *supra*.

The notes issued for the remaining forty percent were no doubt worth substantially less than their face amounts. The depositors "paid" for these notes by promising to refrain from suing to force liquidation. Apparently, a profit motive was involved: by foregoing a small recovery at the time the notes were issued, the recipient hoped eventually to recover the full amount. Although not analyzing this point, the court upheld jurisdiction over the transaction as one involving securities.

The final element in the *Howey* test is that the investor rely on the entrepreneurial or managerial efforts of others. In *Howey*, this criterion was expressed as "solely from the efforts of others."⁹⁷ In *SEC v. Glenn W. Turner Enterprises*,⁹⁸ however, the Ninth Circuit held that

the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities.

Thus, contracts whereby plaintiffs paid for the right to attend Dare To Be Great⁹⁹ classes and the opportunity to recruit others to the scheme were held to be investment contracts within the securities Acts despite the fact that to a significant extent profits would derive from plaintiffs' own efforts. In *United Housing Foundation* the Court took note of the Ninth Circuit's position, but expressed no view on the issue.¹⁰⁰ Nonetheless, the Court adopted the terminology "derived from the entrepreneurial or managerial efforts of others,"¹⁰¹ indicating some retrenchment. Thus, lower level employees of a corporation who purchase stock in their employer, while apparently being excluded from the protection of the Acts by the *Howey* formulation, would appear to be protected under the *United Housing Foundation* reformulation. This liberal approach seems appropriate when viewed in light of the few decisions which have held note transactions to be outside of the Acts because of participation in the affairs of the enterprise; in all such cases involvement at the managerial and entrepreneurial levels has been substantial. Thus, the Seventh Circuit, in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*,¹⁰² in listing the facts that caused it to hold that the notes were not securities, mentioned that "[t]he business enterprise involved was to be operated by the plaintiffs [the issuers], not by the bank or by the defendants."¹⁰³ And in *Oxford Finance Cos. v. Harvey*¹⁰⁴ the court pointedly discussed the problem of participation by the note payee, concluding that since the note payee was a partner in a

97. 328 U.S. at 301.

98. 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

99. See note 78 *supra*.

100. 421 U.S. at 852 n.16.

101. *Id.* at 852.

102. 508 F.2d 1354 (7th Cir. 1975).

103. *Id.* at 1363.

104. 385 F. Supp. 431 (E.D. Pa. 1974).

joint venture in which managerial decisions were approved by both parties, the note could not properly be characterized as an investment.

Recently, the Ninth Circuit, in *Great Western Bank & Trust v. Kotz*,¹⁰⁵ held that an unsecured promissory note given to a bank in exchange for a \$1,500,000 line of credit was not a security, because of significant control exercised by the bank.¹⁰⁶ The bank, by virtue of its superior bargaining position, was able to restrict the uses to which defendant could put his capital, to require defendant to maintain a \$300,000 checking account with the bank during the period of the loan, to require defendant to maintain minimum consolidated working capital of \$4,000,000 and a net current position of at least \$500,000, to prohibit future unsecured borrowing by defendant without the bank's consent, to limit major changes in defendant's corporate structure, and to require the defendant to submit to inspections by the bank.¹⁰⁷ The court explained that the corporate note issuer could do little without answering to the bank and therefore recovery of the note principal and interest did not depend primarily on the managerial efforts of others.¹⁰⁸ It thus appears that to meet the requirement that an investor not be exercising managerial control, the investor must leave routine matters and policy decisions solely to the note issuer.

CONCLUSION

For many years there has been confusion and inconsistency within the federal courts in their efforts to determine what types of notes are to be included as securities under the definitional sections of the 1933 and 1934 Acts. Early decisions construed the phrase "any note" literally, making *any* common law note a security. Federal courts later realized that not all common law notes should be considered securities under the Acts, but these courts weeded out those notes which were not "note securities" on an erroneous basis, construing the phrase "unless the context otherwise requires" to mean context of the transaction. This Comment has urged adoption of a more proper construction of that phrase, to mean context of the statute. Construction of the term "note" then should be undertaken in light of both the economic realities of the transaction at issue and the legislative purpose of the Acts, and only those instruments that are within the ordinary concept of a security should receive the protection of the Acts. The elements of a security suggested by the Supreme Court in *Howey* and recently applied in *United Housing Foundation* offer an analytical framework and useful standards for assessing disputed note transactions. General use of this test should significantly advance the difficult process of defining the term "note" as used in the securities Acts.

105. CCH FED. SEC. L. REP. ¶ 95,494 (9th Cir., Mar. 22, 1976).

106. The bank was relying on future earnings of the corporate note issuer for recovery of the principal and interest. *Id.* at 99,497.

107. *Id.* at 99,498.

108. *Id.* at 99,502.